BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No, 82A-1772
CARL M. AND SANDRA K. PAESEL)

For Appellant: Carl M. Paesel, in pro. per.

For Respondent: Terry Collins Counsel

OPINION

This appeal is made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Carl M. and Sandra K. Paesel against proposed assessments of additional personal income tax in the amounts of $2,349.75, $623.16, and $1,736.41 for the years 1977, 1978, and 1979, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

The sole issue presented for our decision is whether a certain pay allowance received by appellant Carl M. Paesel in 1978 and 1979, while a resident of this state, was properly included in his California income.[2/] His spouse, Sandra K. Paesel, is a party to this appeal only because she filed a joint income tax return with him for the years in question. Therefore, for purposes of this appeal, "appellant" will hereafter refer only to Carl M. Paesel.

On October 14, 1975, appellant accepted an assignment from his Huntington Beach employer, McDonnell Douglas Corporation, to work as a program cost analyst for the European Spacelab Program in West Germany. Under appellant's employment agreement, the term of this foreign assignment was to be at least 18 months, commencing on November 10, 1975. In preparation for his departure, appellant sold his automobile and placed the family residence in Mission Viejo on the market for eventual sale. Appellant and his family then moved to West Germany and lived there for approximately the next year and a half. Due to his daughter's problems in school, however, appellant decided not to accept the customary extension of the contract. Appellant returned to California on April 7, 1977, apparently cutting short the term of his assignment in Europe.

2/ After the filing of this appeal, respondent determined that the proposed assessment for 1977 should be reduced to reflect only an income adjustment made by a federal audit report. Respondent states that appellant has paid this reduced deficiency assessment, leaving no additional tax due for 1977. Portions of the proposed assessments for 1978 and 1979 are similarly based upon federal audit reports. Insofar as they are based on federal determinations, the reduced assessment for 1977 and the assessments for 1978 and 1979 will be sustained without discussion because appellant has failed to present any evidence showing that the corresponding federal audit reports are erroneous. (See Appeal of Royce E. Gum, Cal. St. Bd. of Equal., Mar. 31, 1982.) In addition, respondent has determined that appellant has paid a substantial portion of the 1978 assessment. Based on its computations, respondent agrees that the amount of additional tax due for 1978 is $70.47. The proposed assessment for 1979 reflects the correct amount of additional tax at issue in this appeal.

In connection with this foreign assignment, appellant's employment agreement provided that he was eligible to receive several types of pay allowances in addition to his regular salary. These pay allowances were apparently designed by McDonnell Douglas. Corporation to compensate or reimburse its overseas employees for the various costs and expenses associated with a relocation to and residence in a foreign country. The pay allowance at issue in this appeal has been labeled by appellant as a "tax equalization reimbursement" or "tax equalization payment.' (App. Br. at 8.) The employment agreement states that the purpose of the tax equalization payment was "to protect employes [sic) from the erosion of their compensation due to excessive foreign taxation on Corporate derived pay and allowances only." (App. Br., Ex. 2.) The agreement describes the tax equalization payment as the amount by which appellant's actual tax liability while abroad, including federal and foreign assessments, exceeded what his federal and state tax liability on the same income would have been had he remained in the United States during the same period.

In 1978 and 1979, after reestablishing residency in California, appellant received tax equalization payments of $877 and $21,455, respectively, from McDonnell Douglas Corporation. Appellant did not, however, report any of these amounts on his California personal income tax returns for those two years. Upon review, respondent determined that these payments should have been included in appellant's California taxable income for the years in question and issued the proposed assessments of additional tax. Appellant protested the proposed assessments. Respondent denied the protests, leading to this appeal.

The California personal income tax is to be imposed on the entire taxable income of *every* resident of this state, regardless of the source of the income, and upon the income of nonresidents which is derived from sources within California. (Rev. & Tax. Code, § 17041.) The policy behind California's personal income taxation of residents is to ensure that individuals who are physically present in the state, enjoying the benefits and protections of its laws and government, contribute to its support regardless of the source of their income. (See Cal. Admin. Code, tit. 18, reg. 17014.)

Taxable income is gross income minus allowable deductions. (Rev. & Tax. Code, § 17073.) Gross income is defined as all income from whatever source derived, including compensation for services. (Rev. & Tax. Code,

§ 17071; I.R.C. § 61 (a).) Payments made as an inducement to accept employment or made as part of a bargained-for employment contract to defray obligations or living. expenses related to a job transfer are compensatory in nature and includible in the gross income of an employee. (See Appeal of William L. and Helen M. Hoffman, Cal. St. Bd. of Equal., Dec. 15, 1966; Commissioner v. Starr, 399 F.2d 675 (10th Cir. 1968); Cockrell v. Commissioner, 38 T.C. 470 (1962); Cervilla v. Commissioner, ¶ 76,174 T.C.M. (P-H) (1976).)

In general, payments representing compensation for services are held to be income to a cash-basis taxpayer in the year received as distinguished from the year. in which the compensation is earned, (Rev. & Tax. Code, § 17571; subd. (a); I.R.C. § 451(a); Sivly v. Commissioner, 75 F.2d 916 (9th Cir. 1935); Gamble v. Commissioner, ¶ 80,040 T.C.M. (P-H) (1980).) Since we can safely assume that appellant was a cash--basis taxpayer and he received the tax equalization payments in 1978 and 1979, well after the time he became a resident of this state, it is clear that the payments were income taxable by California,

In rebuttal, appellant has contended that the tax equalization payments are not taxable by this state because they were earned when he was living abroad in West Germany. He takes the position that this income had accrued before he became a resident of California and must, therefore, be excluded from his California taxable income under section 17596, which provides that income which accrued prior to the time that the taxpayer became a California resident is not taxable:

> When the status of a taxpayer changes from resident to nonresident, or from nonresident to -resident, there shall be included in determining income from sources within or without this State, as the case may be, income and deductions accrued prior to the change of status even though not otherwise includible in respect of the period prior to such change, but the taxation or deduction of items accrued prior to the change of status shall not be affected by the change.

In the Appeal of Virgil M. and Jeanne P. Money, decided by this board on December 13, 1983, we concluded that section 17596 was apparently designed merely to prevent California from treating accrual- and cash-basis taxpayers differently when they change residency and are subject to

California tax by virtue of their residency. We held that section 17596 should be applied only when two conditions are satisfied: (1) when California's sole basis for taxation is the residency of the taxpayer, and (2) when the taxation would differ depending on whether the taxpayer uses the cash or the accrual method of accounting.

Applying this two-pronged test to the facts in the present appeal, we find that the first condition is satisfied, for respondent's sole basis for taxing the tax equalization payments is appellant's residency in this state. On the other hand, the second condition is not satisfied because the taxation of these payments would not differ whether appellant was a cash- or accrual-basis taxpayer.

We have already found that the tax equalization payments were taxable if appellant was a cash-basis taxpayer. Under the accrual method, income is includible in gross income when all events have occurred which fix the right to receive such income and the 'amount thereof can be determined with reasonable accuracy. (Cal. Admin. Code, tit. 18, reg. 17571(a): Treas. Reg. § 1.446-1(c)(1)(ii); Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-185 [78 L.Ed. 1200] (1934), reng. den., 292 U.S. 613 [78 L.Ed. 1472] (1934).) If there are substantial contingencies as to the taxpayer's right to receive, or uncertainty as to the amount to be received, an item of income does not accrue until the contingency or events have occurred and fixed the fact and amount of the sum involved. (Midwest Motor Express, Inc. v. Commissioner, 27 T.C. 167 (1956), affd., 251 F.2d 405 (8th Cir. 1958); San Francisco Stevedoring Co. v. Commissioner, 8 T.C. 222 (194%)

If we were to place appellant on an accrual method of accounting, our analysis of when the tax equalization payments accrued would have to consider the amount and timing of the taxes that appellant was required to pay to West Germany. During appellant's tenure in Europe, McDonnell Douglas Corporation had petitioned the West German government for a reduced tax rate for its employees assigned to the spacelab program. Accordingly, the amount of taxes withheld from appellant's payroll checks was computed based on the assumption that the petition would be granted. At this reduced tax rate, appellant was not entitled to receive any tax equalization payments from McDonnell Douglas since his tax liability for the period of his European assignment was less than it would have been if he was employed in

this country. (App. Supp. Ltr., Oct. 10, 1984, at Ex. A.) Thus, when he returned to California on April 7, 1977, appellant did not have a fixed and definite right to receive any payments for excess foreign taxes.

On April 18, 1977, 11 days after appellant became a California resident, the West German Federal Ministry of Finance determined that McDonnell Douglas employees assigned to the spacelab project were not eligible for "special treatment" under its income tax laws but were required to pay taxes at the regular and higher tax rate. (App. Supp. Ltr., Nov. 2, 1984, at Ex. B.) As a result of this decision, appellant's tax liability for the period of his foreign assignment was increased retroactively. Only then did appellant's contractual right to receive the tax equalization payments become fixed and the amount of the income involved become ascertainable. In other words, all of the events establishing entitlement to the income occurred on April 18, 1977. Thus, contrary to appellant's assertion, the tax equalization payments accrued after appellant became a resident of this state. Therefore, under the accrual method, the income was likewise includible in appellant's California taxable income since income accrued subsequent to a change of status from nonresident to resident is taxable as income of a resident, (Rev. & Tax. Code, § 17041; Appeal of John J. and Virginia Baustian, Cal. St. Bd. of Equal., Mar. 7, 1979.)

Because the taxability of the tax equalization payments would not differ whether appellant was a cash- or accrual-basis taxpayer, section 17596 does not apply in this appeal under the principles set forth in Appeal of Virgil M. and Jeanne P. Money, supra. We observe, however, that even if section 17596 did apply to this case and require us to treat appellant as if he were on the accrual method of accounting, we would reach the same result and find the payments in question to be taxable. Thus, respondent's determination that these allowances were includible in appellant's California taxable income was correct. Accordingly, the assessments of the deficiencies in 1978 and 1979 corresponding to the tax equalization payments must be sustained.

Appeal of Carl M. and Sandra K. Paesel

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Carl M. and Sandra K. Paesel against proposed assessments of additional personal income tax in the amounts of $2,349.75, $623.16, and $1,736.41 for the years 1977, 1978, and 1979, respectively, be and the same is hereby modified in accordance with respondent's concessions. In all other respects, the action of the Franchise Tax Board is sustained,

'Done at Sacramento, California, this 30th day of July , 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

_____, Chairman

William M. Bennett, Member

R i c h -, Member

Walter Harvey*, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9